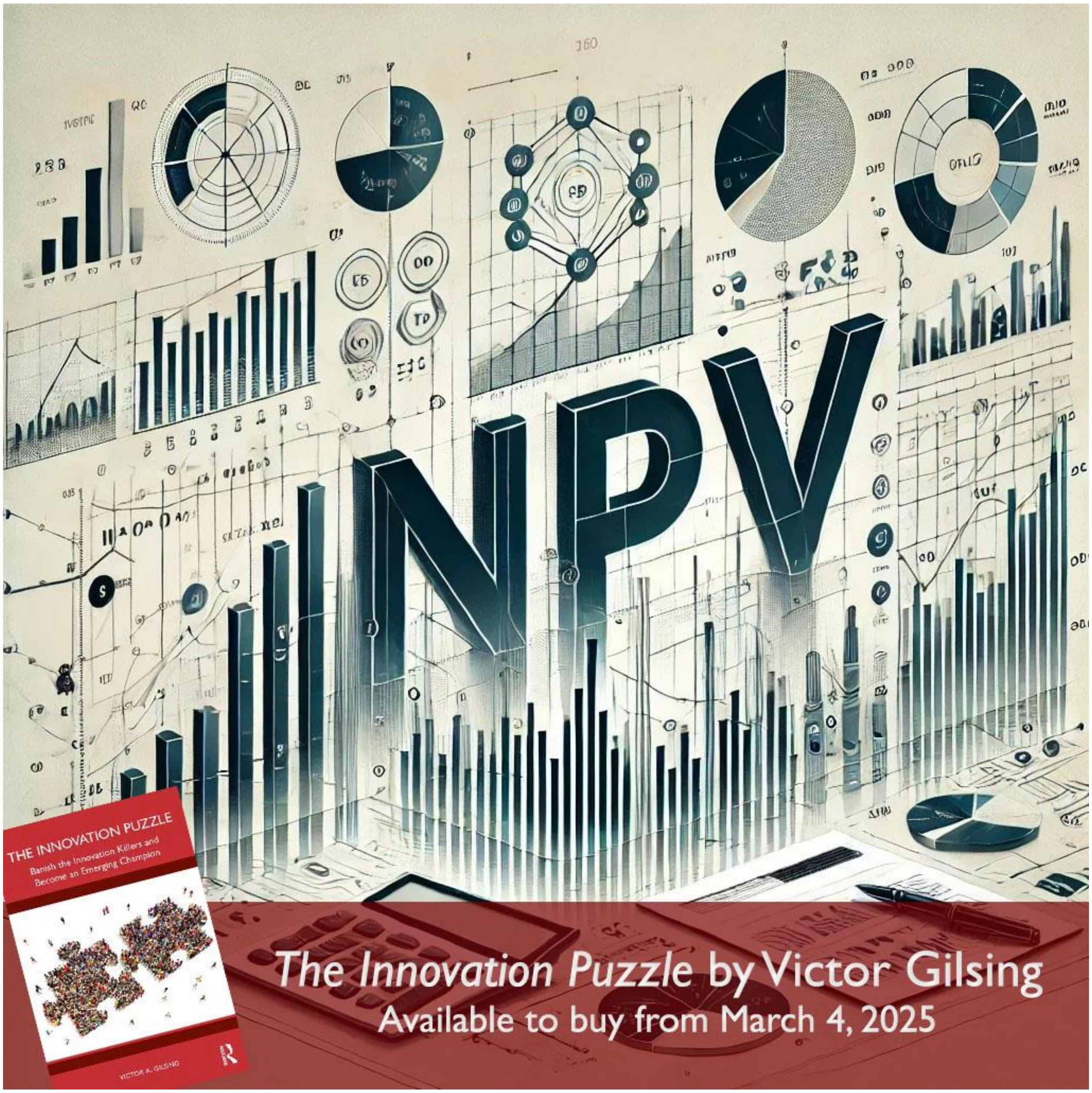

The Misuse of Financial Metrics in Evaluating Innovation

Most executives recognize innovation is essential for securing long-term business competitiveness, yet many struggle to turn innovation into a repeatable success. One major reason? As I discuss in my new book *The Innovation Puzzle* they apply **the wrong metrics** to evaluate new ventures.

Metrics like **Net Present Value (NPV), Internal Rate of Return (IRR), and Payback Time** are widely used to assess investments in core business operations. Don't get me wrong: these metrics have a valuable role to play in business. They work well in **stable, predictable environments** where financial projections are based on historical data.

But when these same metrics are applied to **new, uncertain, and disruptive innovations**, the result can be nothing short of disastrous.

Why? As I point out in my book, in the context of innovation, they have three fundamental flaws:

1. **Short-Term Bias**: NPV and IRR favor immediate returns, whereas innovation is a long-term game. When companies use NPV and IRR as their reference point for innovation, they end up underfunding projects.
2. **Illusion of Predictability**: Conventional reporting metrics are designed for mature product lines whose revenue generation tends to be stable and predictable. New, innovative products, on the other hand, often explore unknown markets where future revenues are highly uncertain. Using these metrics leads decision makers to believe that the financial performance of innovative products should be predictable. And when it's not, they tend to feel an urge to cut (what they perceive as) their losses.
3. **Penalty for Uncertainty**: Higher risk leads to higher discount rates in financial models, making game-changing innovations look unattractive on paper.

In *The Innovation Puzzle* I give a few case-study examples of how relying on these kinds of metrics have hampered companies' innovation efforts. One is **Intel's failure in processors for mobile devices**. The company had the technology, the talent, and the market opportunity. But it evaluated its mobile initiatives using **cash-flow-based steering**—the same method applied to its core semiconductor business. The result was grim: chronic underinvestment, hesitation, and ultimately, ceding the market to competitors like Qualcomm.

This is the **one-size-fits-all trap**—taking financial logic that corresponds to core business imperatives and applying it to types of investments that are fundamentally different, innovation being one of these. When companies do this, they don't just miss out on opportunities; they actively kill them before they have a chance to succeed.

So, what's the alternative? Simple: companies must **rethink how they measure innovation**. Here are some ways I suggest in the book to achieve just that:

- **Use milestones, not just financials**: Evaluate progress based on technological feasibility, customer adoption, and market validation.

- **Segment investment criteria**: Apply different evaluation methods for **incremental, adjacent, and radical innovations**.
- **Incorporate strategic value**: Some innovations redefine entire industries. Metrics should account for their game-changing potential and securing long-term competitiveness

Financial discipline is crucial, but if companies continue to assess disruptive innovation **as if all they are doing is expanding output of an existing product**, they will fail to build the future.

I'd be interested to hear from you about how the companies you've worked at have tried to quantify innovation work. Did their metrics nurture or thwart new product ideas?